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Plugging tax loopholes: How reform could boost revenue

A $100 million cost to services that lawmakers could fix, as 25 states have done

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Business cycles come and go, as do budget challenges. But there is one constant: **Iowa loses many tens of millions of dollars every year to corporate tax loopholes** — as much as $60 million to $100 million.[1] This creates instant revenue shortfalls, lessens accountability and is unfair to Iowa-focused businesses that do not avoid taxes.

Because these loopholes remain open, Iowa does not receive revenue that the corporate tax code was designed to collect.[2] **While the state would secure more tax revenue, it could do so without raising tax rates** on anyone or by expanding the kinds of income that would be taxed. **Instead, it would plug "tax loopholes"** — seams in the tax code that permit companies to shelter income from tax by shifting profits to tax-haven states, such as Delaware, Arkansas or Nevada.

The tool to plug these loopholes is a tax policy known as **"combined reporting,"** which is used in 25 states and Washington, D.C. — including **Illinois, Minnesota, Wisconsin, Nebraska and Kansas.** Combined reporting would treat multistate and multinational corporations like home-grown Iowa businesses that do not have the ability to shift profits to tax haven states such as Delaware, Arkansas or Nevada.

The problem that needs fixing

- Multistate companies are quite sophisticated at sheltering their Iowa income from Iowa tax; the Iowa Department of Revenue, as noted above, in 2007 estimated the cost at $60-$100 million.[3] Those estimates are based on tax years 2002 and 2003. At the very least, a new study would give an idea how changes, such as mergers creating larger multistate firms, would affect the costs.
- When multistate companies can exploit cracks in Iowa's tax code to avoid taxes while their competitors that operate primarily in Iowa cannot, it leaves an uneven playing field.
- While some states have challenged tax returns of corporations using loopholes, that means a protracted and costly legal process that otherwise could be avoided by changing tax law.

Unlike a tax increase, combined reporting is an accountability tool that assures a state can enforce its existing tax code against tax-avoidance gimmicks.

How do they do it?

Already, existing tax breaks for business are many, particularly in the area of tax credits, now at a cost of about $300 million a year — $400 million a year if including property tax credits.[4] **Loopholes differ from tax credits, exemptions and deductions that have been passed as specific exceptions to the tax code**. They are unintended. When companies find ways around the law to provide themselves a tax break, they divert revenue from its intended public purpose to their own interests. This lessens revenue available for public services, and tilts the scale against competitors who might not be able to benefit from the break they have discovered. Examples:

- The "Geoffrey Loophole." Named for the Toys R Us mascot Geoffrey Giraffe, the loophole permits a multistate company to create a separate entity in a state that does not tax royalty income (Delaware), then have that subsidiary charge royalties for use of a logo or name. This reduces profit in the original state where sales are made (Iowa), and thus tax owed in that state (Iowa).
- The Real Estate Investment Trust (REIT) loophole. Similarly to the Geoffrey loophole, a company shifts profits through entities in various states to shield income from tax. A Wall Street Journal article in 2007 reported that Walmart avoided $350 million in state taxes in various states with this strategy.[5]
- For others, see IFP's 2004 booklet, "*Everything You Wanted to Know about Closing Tax Loopholes and Balancing Iowa's Budget — But Were Afraid to Ask."*[6]

Adopting "combined reporting" to plug those loopholes would not affect most Iowa businesses with Iowa-focused operations. Rather, it would treat small Iowa firms and large multistate companies the same — taxing them on their Iowa income.[7]

As Michael Mazerov of the Center on Budget and Policy Priorities has noted,[8] Iowa is susceptible to loophole schemes because of its "single-factor" corporate income tax, which is based only on a company's sales apportioned to Iowa. Without a mechanism such as combined reporting to assure all profits are reported together before apportionment for tax purposes, companies avoid tax.

Conclusion

It has been over a decade since there was any serious discussion of adopting combined reporting, which Iowa lawmakers have rarely debated even at the committee level. When revenues are tight and corporate tax reform of any kind is being discussed — as it is in 2018 — plugging corporate tax loopholes with combined reporting is an option that demands attention for fairness, accountability and revenue.

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[1] *Jay Munson, "Combined Reporting: An Option for Apportioning Iowa Corporate Income Tax," Iowa Department of Revenue, March 2007.*

[2] *Iowa's business lobby has long fought any consideration of combined reporting, these business lobbying groups including the Iowa Association of Business and Industry and the Iowa Taxpayers Association.*

[3] *Ibid. https://tax.iowa.gov/sites/files/idr/IDRCombinedReportingCorpTax.pdf*

[4] *Iowa Fiscal Partnership, "Sensible improvements for Iowa taxes," October 2017, http://www.iowafiscal.org/sensible-improvements-for-iowa-taxes/*

[5] *Jesse Drucker, "Wal-Mart Cuts Taxes by Paying Rent to Itself," The Wall Street Journal, Feb. 5, 2007.*

[6] *Iowa Fiscal Partnership, February 2004. https://iowapolicyproject.org/2002-2004docs/040204-loopholes-guide.pdf*

[7] *Peter Fisher, Iowa Fiscal Partnership, "Leveling the Playing Field," April 2007. http://www.iowafiscal.org/leveling-the-playing-field/*

[8] *Michael Mazerov, Center on Budget and Policy Priorities, "The 'Single Sales Factor' Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?" https://www.cbpp.org/archives/3-27-01sfp.htm*

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